

Internal Revenue Service
memorandum

CC:TL-N-8057-87

Brl:CButterfield

date: JUL 16, 1987

to: District Counsel, Louisville CC:LOU

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED]

This is in response to your request for technical advice by memorandum dated May 29, 1987.

ISSUE

Whether a deduction should be allowed for accruals of liabilities under workmen's compensations claims which have been filed and awarded and agreed to or are otherwise uncontested. Rira Nos. 0162.07-04, 0461.01-02.

CONCLUSION

In view of recent Supreme Court opinions as well as Fourth Circuit and other precedents on this issue, we recommend conceding the deductibility of uncontested claims for worker's compensation at the time that the award becomes final.^{1/}

FACTS

[REDACTED] is a manufacturer of [REDACTED], with principal offices in West Virginia. In [REDACTED], [REDACTED] became self-insured for workmen's compensation coverage for its employees. In West Virginia this coverage is normally provided through a state fund into which employers pay premiums and from which benefits are paid to physicians, hospitals, and the injured employees. Before the [REDACTED] election to become self-insured, [REDACTED] had been a participant in the state fund.

^{1/} This concession will apply only to years before 1984, as I.R.C. § 461(h), as passed in the Deficit Reduction Act of 1984, Pub. L. 98-369, and the regulations thereunder, will require economic performance (i.e. actual payment of the claims) before worker's compensation payments may be deducted for years after 1984.

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As part of its election to leave the state fund, [REDACTED] had to agree to assume an obligation to repay the state for benefits paid on claims arising from injuries occurring before the election for which awards had not yet been made. Payments under this agreement were made before [REDACTED]. For the fiscal year ended [REDACTED], [REDACTED] created a liability account on its books for the amounts owed to the state for the above-referenced claims, and amounts for which [REDACTED] was liable on claims that arose and were awarded and agreed to after [REDACTED] became self-insured. Contested claims are also reflected as a liability on [REDACTED]'s books. However, they have only claimed a deduction for uncontested amounts. The deduction they have claimed reflects the present value of the liabilities to be paid over time. This plan met the statutory requirements of the State of West Virginia.

The amounts of deducted claims are determined by actuarial estimate or based on past experiences with similar type claims. [REDACTED] employs the firm of [REDACTED] to administer its compensation program. This firm makes the determination of the amount of each claim, and is responsible for paying the employees amounts owed to them under the program. For fiscal year [REDACTED], [REDACTED] deducted \$[REDACTED] in expenses attributable to its insurance program. (Due to a miscomputation by the examiner, this amount was shown as \$[REDACTED] in the proposed adjustment. This miscalculation was pointed out by taxpayer's representative, who also pointed out that the deduction should be increased by \$[REDACTED], for amounts paid to the state during the period of transition to self-insurance.) \$[REDACTED] of this amount was actually paid out in the year deducted. \$[REDACTED] of the total amount is attributable to the total disability of a single employee. The amount was derived by the use of Department of Health and Human Services actuarial tables.

LEGAL ANALYSIS

I.R.C. § 461 states that deductions shall be taken in a manner consistent with the accounting method used to calculate taxable income. Treas. Reg. §1.461-1(a)(2) incorporates the all-events test into section 461 for accrual method taxpayers. The regulation requires that deductions be taken in the year in which all events have occurred that fix the liability and in which the amount can be estimated with reasonable accuracy. Thus the test is considered to have two prongs, the first prong being whether or not liability is fixed, the second whether the amount of liability can be estimated with reasonable accuracy. While estimates are permissible under the second prong of the test, actual liability is required for the first. Numerous courts have analyzed these provisions, particularly with regard to deductions for benefits payable under workmen's compensation programs. Central to all the judicial analyses of the all events test is the issue of liability under the first prong of the test.

In this case the question is not whether or not some liability exists, but whether that liability is sufficient to accrue under the all events test. We have concluded based on the most recent Supreme Court opinions on the subject, as well as numerous earlier opinions, that uncontested workmen's compensation claims may be accrued as fixed liabilities.

The most recent Supreme Court opinions on the all events test are United States v. Hughes Properties, ___ U.S. ___, 106 S.Ct. 2092 (1986) and United States v. General Dynamics, ___ U.S. ___, 107 S.Ct. 1732 (1987). In Hughes Properties the issue was when liability could be accrued and deducted for amounts showing on casino slot machines, where state law prohibited the reduction of those face amounts except upon payment to a winning player, and the amounts had not yet been won. The Court held that absent remote and unlikely events, the amounts would be won in full at some point, and therefore, all events had transpired to fix the face amounts of the jackpots at the close of the casino's fiscal year. In Hughes Properties, therefore, it was of critical importance that the statute fixed the liability. The General Dynamics case was decided on a similarly narrow determination of liability. In General Dynamics, the Court determined that as a matter of law no liability existed for the payment of health insurance claims by a self-insuring company until claims had been filed. The Court rejected the taxpayer's argument that liability was fixed at the time that the injury occurred. The coverage provided by General Dynamics was not part of a statutory scheme similar to workmen's compensation; the terms of the medical care plan determined when liability became fixed.

In General Dynamics, the Court rejected taxpayer's estimate of future liability for medical benefit expenses which was based on data from previous insurance carriers. The Court disagreed with the conclusion of the courts below that the last event necessary to fix taxpayer's liability was the receipt of medical care by covered individuals and that General Dynamics could deduct an estimate of its obligation to pay for medical care. The Court held that filing a claim for reimbursement was crucial to the establishment of liability and noted that the mere receipt of services, for which claims may not be submitted, is not the last link in the chain of events creating liability for purposes of the all events test.

Venue in this case lies within the Fourth Circuit Court of Appeals. A Fourth Circuit case providing guidance on the issue of liability fixed by statute is Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951). Harrold dealt with a statutory requirement that strip-mined lands be reclaimed once mining was completed. In Harrold, the Court determined that all events necessary to fix the liability for the expense of reclamation had taken place at the time mining endeavors ceased because

the statutory requirement fixed liability at that time. The court allowed estimates to be made of reclamation costs per acre, and allowed these costs to accrue when mining of that acre was complete. In the Harrold case the taxpayer was also required to post a bond, under a state law provision, in the amount of the estimated cost of reclamation, which was forfeited in case of nonperformance. Under the circumstances in Harrold, where the bond in the amount of the claimed deduction had been posted, given the recent Supreme Court pronouncements on this issue, we believe that the posting of the bond and the mining of the land are the final events necessary for satisfying the first prong of the all events test. The court determined that this method of accounting not only satisfied the all-events test, but comported with the principle that expenses should be accounted for on an annual basis with the corresponding income generated by their incurrence.

Two other cases that reached similar conclusions more recently are Imperial Colliery v. United States, 599 F. Supp. 653 (S.D.W.V. 1984) and Buckeye International, Inc., T.C. Memo 1984-668. Both these cases dealt with self-insured employers under workmen's compensation statutes. In Imperial Colliery, the court (following the reasoning in Crescent Wharf and Warehouse Company v. Commissioner, 518 F.2d 772 (9th Cir. 1975), discussed below) determined that in an uncontested workmen's compensation claim the liability is fixed at the time the injury occurs. Subsequent considerations such as an official determination of the degree of disability go to the second prong of the test - that is they must be present in order to determine the amount of liability. In Buckeye the Tax Court considered workmen's compensation claims awarded by the Ohio State Industrial Commission. The court found that liability for amounts awarded by the commission accrued at the time the commission made its award and factors such as the subsequent remarriage or death of a beneficiary would fall in the category of events subsequent, and would not prevent the accrual of liability in the first instance. We perceive some logical inconsistency within the Imperial Colliery opinion, which states that in an uncontested claim liability accrues from the date of injury, because some action subsequent to injury would be required to establish that a claim was uncontested. We would be unwilling at this point to concede the broader issue of liability being accrued before that subsequent event had taken place. We believe that under these circumstances the final event in the chain would be the formal decision not to contest a filed claim. This inconsistency does not present a difficulty in your case, however, since the awards have been made and conceded. The result under these cases is consistent with a strict interpretation of legal liability as discussed in General Dynamics and Hughes Properties; thus under all applicable law the first prong of the all events test would be fulfilled in

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The Supreme Court has not provided us with an analysis of the Ninth Circuit cases in this area in spite of the recent activity. Crescent Wharf, mentioned above, states the Ninth Circuit opinion that liability accrues at the time of injury where said liability is fixed by statute. The later case of Kaiser Steel Corp. v. United States, 717 F.2d 1304 (9th Cir. 1983) takes the same view. To the extent that these cases allowed deductions for liabilities where the statute required a claim to be filed and such a claim had not been filed, General Dynamics would overrule them. Also, to the extent that the deductions were for estimates of future liability based on past experience they may be considered invalid. We will continue to litigate deductions based on estimates of future liability based on past experience. However, where an injury has occurred for which a statute requires that payment be made, and a claim for such payment has been filed and is uncontested, Hughes Properties and General Dynamics would allow a deduction. As stated above, we are not prepared to concede the larger area of liability accrued before claims have been filed.

Generally, once the first prong has been satisfied, an actuarial estimate of the amount of liability will be sufficient to meet the second prong requirement. Imperial Colliery, 518 F.2d 772; Buckeye International, T.C. Memo 1984-668. Taxpayers in [REDACTED] have made a reasonable estimate of the amounts they will have to pay, particularly with regard to the one case of permanent disability. In determining [REDACTED]'s workman's compensation expense liability, the program administrator ([REDACTED]) utilizes prior experience with similar claims and physician's reports on the extent of injury. Lost wage liability is based on the West Virginia Workman's Compensation Fund formula (type of injury percentage x severity percentage x weekly wages x time period) and for permanent disability the amounts of liability are based on actuarial tables generated by the Department of Health and Human Services. Taxpayers have gone a further step and taken a deduction only for the present value of the amount of the liability. There is nothing in the Code which requires them to limit their deduction to the present value of the liability. Once they have passed the hurdle of the first prong analysis, a supportable argument can be advanced that a deduction is allowed for the full amount of the liability. However, to the extent that the payment period extends so far into the future that a distortion of income would result from a present deduction, the Service could then argue that the Commissioner was entitled to disallow the entire deduction, or to reduce the amount of the deduction to amounts payable in the near future, so that the deduction accurately reflects income. In Mooney Aircraft v. United States, 420 F.2d 400 (5th Cir. 1969), taxpayers were in the business of selling airplanes. With each airplane sold taxpayers included a "Mooney bond" which was a promise to pay \$1000 at the time that the airplane was retired. Although these bonds would not be payable for 25-30 years after issuance,

taxpayers took the deduction at the time the plane was sold. The court disallowed the deduction although they found that the liability was fixed, because they found that allowing taxpayers to take a deduction for an expenditure that they would not have to make for such a long span of time would result in a distortion of income.

In the legislative history to section 461(h), Congress clearly indicated that a present value deduction was not required under current law by section 461, and section 461(h) served as an alternative to a present value requirement as a lesser administrative burden. H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess., 1254 (1984); S. Rep. No. 169, Vol. 1, 98th Cong., 2d Sess., 266 (1984). The taxpayer in this case may seek to take a deduction in later years for the difference between the present value deduction they are taking at this time, and the amount they actually pay out in the later years. They would be entitled to adopt this treatment of their expenditure under the pre-1984 code.

In sum, we believe that the body of case law up to Hughes Properties and General Dynamics precludes our disputing the validity of the type of deduction the taxpayer here has claimed. We therefore recommend conceding the entire claimed deduction. If you have any questions regarding this matter, please contact Ms. Clare Butterfield at 566-3521.

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